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PCAOB Rulemaking Docket Matter No. 37: Concept Release on Auditor Independence and Audit Firm Rotation

Dear Chairman Doty,

Siemens Aktiengesellschaft appreciates the opportunity to comment on the PCAOB Concept Release on Auditor Independence and Audit Firm Rotation.

We structured our comment letter as follows:

A. General remarks
B. Specific comments addressing the questions in the concept release

A. General Remarks

We support the continued efforts of the PCAOB to enhance auditor independence, objectivity and professional skepticism and hence audit quality. However, we disagree with the proposal of mandatory audit firm rotation.

We acknowledge that the auditor payment model, depending on the circumstances, may create a conflict of interest for an auditor. However, we strongly believe that the current rules and regulations adopted by the SEC in response to the Sarbanes-Oxley Act of 2002 appropriately address this issue. This applies, but is not limited, to the establishment of, and regular inspections by, the PCAOB, the mandatory rotation of lead audit partners after five years, the appointment, removal and oversight of the engagement by the audit committee, the reporting requirements of the auditor to the audit committee and the pre-approval of permissible non-audit services by the audit committee. The standards continuously issued by the PCAOB in the last years efficiently enhanced auditor independence, objectivity and professional skepticism and thus sufficiently mitigate that conflict.

We kindly ask the PCAOB to further analyze whether the audit deficiencies it had identified in its inspections could actually be tied to a lack of independence, objectivity and professional skepticism before continuing with a proposal like mandatory audit rotation.

We believe the potential benefits cited by proponents do not outweigh the potential risks associated with mandatory audit firm rotation. It is our view that the information loss through a regular change of the audit firm tends to diminish the audit quality, especially in the first years after the rotation. This is because of the continuous

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challenges related to gaining knowledge of the client's business, systems and processes associated with mandatory rotation.
Additionally we are concerned about the increase in transition costs for companies and ultimately their investors, as time and money associated with evaluating, selecting and educating new auditors on a rotating basis will be significant.

Hence, the appointment of audit firms should adequately balance the pros and cons of continuity and change when determining on auditors' rotation. Because of their in-depth knowledge of the company, we believe the audit committee is best suited to decide, in the interest of the shareholders, whether and when to rotate auditors.

B. Specific comments concerning the questions in the concept release

General Questions

– (a) Should the Board focus on enhancing auditor independence, objectivity and professional skepticism? How significant are the problems in those areas relative to problems in other areas on which the Board might focus? Should the Board simply defer consideration of any proposals to enhance auditor independence, objectivity and professional skepticism?

(b) Would audit firm rotation enhance auditor independence, objectivity and professional skepticism?

(c) What are the advantages and disadvantages of mandatory audit firm rotation? If there are potential disadvantages or unintended consequences, are there ways a rotation requirement could be structured to avoid or minimize them?

(d) Because there appears to be little or no relevant empirical data directly on mandatory rotation available, should the Board conduct a pilot program so that mandatory rotation of registered public accounting firms could be further studied before the Board determines whether to consider developing a more permanent requirement? How could such a program be structured?

(e) According to the 2003 GAO Report, large firms estimated that a rotation requirement would increase initial year audit costs by more than 20 percent. What effect would a rotation requirement have on audit costs? Are there other costs the Board should consider, such as the potential time and disruption impact on company financial reporting staff as a result of a change in auditors? Are there implementation steps that could be taken to mitigate costs? The Board is particularly interested in any relevant empirical data commenters can provide in this area.

(f) A 2003 report by the Conference Board Commission on Public Trust and Private Enterprise recommended that audit committees consider rotation when, among other factors, "the audit firm has been employed by the company for a substantial period of time— e.g., over 10 years." To what extent have audit committees considered implementing a policy of audit firm rotation? If audit committees have not considered implementing such a policy, why not? What have been the experiences of any audit committees that have implemented a policy of rotation?

(g) Are there alternatives to mandatory rotation that the Board should consider that would meaningfully enhance auditor independence, objectivity and professional skepticism? For example, should broader alternatives be considered that relate to a company's requirement to obtain an audit, such as joint audits or a requirement for the audit committee to solicit bids on the audit after a certain number of years with the same auditor? Could audit committee oversight of the engagement be otherwise enhanced in a way that meaningfully improves auditor independence?

(h) Should the Board continue to seek to address its concerns about independence, objectivity and professional skepticism through its current inspection program? Is there some enhanced or improved form of inspection that could better address the Board's concerns? If mandatory rotation were in place, could an enhanced inspection, perhaps focused particularly on professional skepticism, serve as a substitute in cases in which it would be unusually costly, disruptive or otherwise impracticable to rotate auditors?

a) In order to achieve continuing improvement in audit quality, the Board has appropriately enhanced auditor independence, objectivity and professional scepticism by issuing various auditing and related professional practice standards for registered public accounting firms to follow in the preparation and issuance of audit reports.
In order to determine the significance of any issues related to auditor independence, objectivity and professional scepticism are, we agree with board members Daniel L. Goelzer and Jay D. Hanson that a detailed further analysis of the PCAOB inspection results and other available information relating to the circumstances and root causes of audit failures is necessary. The analysis will reveal whether the increase in significant deficiencies that PCAOB inspectors identified in 2010 results from audit tenure and a lack of auditor independence or from other causes, such as a lack of technical competence or experience, staffing or other issues. Therefore we highly suggest that the PCAOB further analyzes the inspections results as a basis for any conclusions and proposals relating to enhancing auditor independence, objectivity and professional scepticism.
The actions to enhance audit quality implemented by the SEC in response to the Sarbanes Oxley Act in 2002, e.g. lead and concurring audit partner rotation every five years and seven-year rotation for certain other partners start to become fully effective for many companies in 2010. In addition, the PCAOB issued several standards to increase auditor objectivity and professional skepticism in 2009 and 2010, which now start to be fully implemented. We suggest deferring any proposals to enhance auditor independence, objectivity and professional scepticism until the full implementation of these requirements has been subject to PCAOB inspections and those PCAOB inspection results have been thoroughly analyzed.

b) No, we strongly disagree with mandatory audit firm rotation because the benefits associated with sensible continuity in the audit business overweigh. We believe the loss of knowledge and understanding developed by the audit firm through a regular change of the audit firm tends to diminish the audit quality. We also believe that audit firm rotation results in the risk that in the first years after the rotation audit quality may suffer because of the challenges related to gaining appropriate knowledge of the client’s business, systems and processes associated with mandatory rotation. Typically, a change of auditor will lead to significant transition costs and especially extra time and commitment, including senior personnel at the audited company explaining their business, internal control environment, processes and corporate structure to the new auditor. The required changing of auditor can be very challenging for a company if the transition phase to the new auditor coincides with a significant transaction, such as a merger or acquisition or during difficult market situations, e.g. a financial crisis. Furthermore, if the audit firms have to be changed regularly, the new auditor would probably have to audit the outcome of services which he provided before his engagement as auditor of the company. This could trigger the loss of independence for many firms.
Because of their in-depth knowledge of the company, we believe the audit committee is best suited to decide whether, and when, to rotate auditors. However, mandatory audit firm rotation would not allow audit committees to consider facts and circumstances relevant to changing auditors and thus reduce the responsibility of the audit committee. Mandatory audit firm rotation is not in line with our general belief that the audit committee should be strengthened.
The existing independence rules including audit partner rotation requirements, and the natural turnover at a company’s finance staff and audit committee members together with the appointment, removal and oversight of the audit engagement by the audit committee is sufficient to promote auditor independence by not diluting the overall knowledge of the audited company’s risks.

c) As mentioned above under b) we see the information loss, the risk of audit failure in the first years and the additional efforts required to provide the new auditor with insights in the company as major disadvantages of mandatory audit firm rotation. In addition, a regular audit tender process after each rotation period will bind valuable resources on the side of the company and as well on the side of the auditor, which could otherwise contribute to improving the financial reporting or respectively the audit quality.
We see no practical way to avoid or minimize the disadvantages resulting from mandatory audit firm rotation.

d) As there are currently almost no legal requirements for mandatory audit firm rotation in place and voluntary mandatory audit firm rotation may not be frequent in current practice a study or pilot program might be difficult to perform. In Italy, one of the few countries where mandatory audit firm rotation is legally required (every 9 years) several studies on the effects of mandatory rotation revealed that mandatory audit firm rotation is detrimental to audit quality and that audit quality tends to enhance with audit tenure. A result of a survey in 2003 was that partner suspensions mainly concentrated in the first year of an appointment, i.e. in which it is assumed that the auditor still has not enough knowledge of the audited company and qualified audit opinions have the highest frequency in the third year, i.e. when it is assumed that the auditor has gained enough knowledge.

Additionally, we believe that the results from a new study might not significantly differ from the results of the GAO report of 2003 on mandatory audit firm rotation, since the requirements of the Sarbanes Oxley Act of 2002 and the standards issued by the PCOAB in the last years on auditor independence, objectivity and professional scepticism have only recently become fully effective and thus cannot yet be fully assessed.

e) We believe that mandatory audit firm rotation will significantly increase the costs of the audit firm as additional man-hours are necessary during an increased number of audit tender processes and once appointed, to “get to know” the client. For large complex international groups this may lead to a very significant number of additional man-hours. And also for the client, internal costs, which might not be easily measured, will increase due to the additional resources required in the tender phase and also for the training phase in the initial years of the audit. Each time rotation occurs, the financial reporting staff and management and to a certain degree also the audit committee face disruption, expense and time involved in educating the new audit firm about the operations of the company and financial reporting issues. We see no practical way to reduce these costs.

f) Our audit committee has not implemented a policy on audit rotation. Because of their in-depth knowledge of the company the audit company is best suited to decide whether and when to rotate auditors. The audit committee should be free to appoint the audit firm that best meets their needs and decide based on the relevant facts and circumstances when to change auditors. In an environment of mandatory audit firm rotation audit committees lose control of selecting the best auditors that provide the best quality to shareholders since the incumbent firm would not be eligible to compete to provide audit services for some period of time.

g) We support the alternatives brought up by board member Daniel L. Goelzer to empower the SEC or the PCAOB to require rotation on a case-by-case basis when an inspection finds that long audit tenure and lack of independence have intersected to result in an audit failure. Another scenario where we could imagine a mandatory audit rotation is when a company continues to engage an auditor who has repeatedly provided insufficient service. In these cases the additional costs and risks associated with audit firm rotation are justified by additional benefits because in these cases audit quality actually suffered.

We do not support a requirement for the audit committee to solicit bids after a certain number of years due to costs and efforts associated with every audit tender process on company side as well as on the side of the auditor. An audit tender process is extremely time consuming, involving senior personnel at the audited company as well as senior audit personnel at the audit firm. These resources are better off in actually performing audit work and increasing audit quality.

We consider a requirement for audit committees to perform a periodic evaluation of the audit quality and whether audit firm rotation would be beneficial as a better approach to increase audit quality. Additionally, the Audit Committee could be required to explain the retention of the auditor after more than a set period of years (e.g. 10 years).
We also support the efforts of the PCAOB to better inform audit committees about the PCAOB inspections and any other efforts of the PCAOB to strengthen the audit committee oversight of the audit process.

We strongly disagree with the proposal of mandatory joint audits. For a globally acting company, joint audits are likely to not increase the quality of the performed audit. This is because for multinationals the timely preparation of financial statements not only requires highly skilled auditors but also expeditious workflows. A delay of the audit work is not tolerable in today’s environment.
Multinationals often carry out transactions across different companies within a group, often including cross border transactions. In a joint audit, the different elements in these transactions require the involvement of several audit firms in order to provide an audit opinion. The coordination of audit work is time consuming, potentially delaying the audit opinion beyond what is accepted by regulators and markets.
In addition a joint audit might decrease the ability to gain a comprehensive view on specific areas of financial reporting. For example, an audit committee may want to understand the accounting quality of cross border transactions exceeding a specific amount. While a single auditor will typically be able to gather this information, a group of joint auditors might not have the respective organizational structures in order to provide this information to the audit committee.
It is of note that companies’ audit committees are free to opt for a joint audit if they think this best suits the needs of the users of the relevant financial statements. However, in practice joint audits are rare as they create challenges in coordination between the auditors, as well as additional cost because of work carried out twice and risks of gaps.

h) We strongly support that the PCAOB continues addressing its concerns about independence, objectivity and professional scepticism through its current inspection program. We suggest examining the inspections findings in detail in order to have more information about the source of the audit failure, i.e. lack of independence, objectivity, professional scepticism or lack of technical competence or resources. We currently see no better form of inspection. As laid out above, we strongly disagree with mandatory audit firm rotation. We believe that a mandatory audit firm rotation requirement with exceptions for cases in which it is unusually costly, disruptive or otherwise impracticable to rotate auditors will be difficult to implement in practice.

IV. Possible Approaches to Rulemaking
A. Term of Engagement

(1) If the Board determined to move forward with development of a rotation proposal, what would be an appropriate term length?

(2) Should different term lengths for different kinds of engagements be considered? If so, what characteristics, such as client size or industry, should this differentiation be based on?

(3) Does audit effectiveness vary over an auditor's tenure on a particular engagement? For example, are auditors either more or less effective at the beginning of a new client relationship? If there is a "learning curve" before auditors can become effective, generally how long is it, and does it vary significantly by client type?

(4) Some have also suggested that, in addition to being less effective at the beginning of an engagement, an auditor may be less diligent toward the end of the allowable term. On the other hand, others have suggested that auditors would be more diligent towards the end of the allowable term out of concern about what the replacement auditor might find. Would auditors become more or less diligent towards the end of their term? Does the answer depend on the length of the term?

(5) How much time should be required before a rotated firm could return to an engagement?

(1) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(2) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(3) Yes, we believe that audit effectiveness varies over an auditor’s tenure on a particular engagement. Audit quality is generally lower in the first years of an engagement when the new auditor gains knowledge about a company’s business, information systems and processes that support financial reporting. This learning process increases with the size, complexity and global exposure of a company. Companies devote substantial effort to this transition process, diverting resources from the financial reporting process which might increase the risk of reporting errors.
We believe that audit tenure will actually increase audit quality and thus investor protection as auditors attain significant knowledge and awareness of risks of a company over time, which is especially important in the current environment of increasing complexity. Another critical point and cause for an audit failure during the transition phase to a new auditor are significant ongoing transactions in a company, such as a significant merger or acquisition or with difficult market situations, such as a financial crisis.
A study on the effects of audit tenure and auditor change on audit quality, in Italy, one of the very few real mandatory audit firm rotation environments, revealed that audit quality tends to enhance with audit tenure.[1]

(4) We agree that in addition to being less effective at the beginning of an engagement, an auditor may be less diligent toward the end of the allowable term. We believe that there is a high risk at the end of a rotation period, independent of the length of the engagement term, because companies might be distracted with planning the transition to the new auditor. On the side of the audit firm there is the risk that the audit firm may rotate its most qualified staff of the engagement during the later years of audit tenure because the audit firm might focus its resources on obtaining or providing service to the next post-rotation audit engagement.

(5) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

[1] M. Cameran, A. Prencipe, M. Trotta, Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?, Bocconi University and IE Business School, 2010

IV. Possible Approaches to Rulemaking
B. Scope of Potential Requirement

(6) Should the Board consider requiring rotation for all issuer audits or just for some subset, such as audits of large issuers? Should the Board consider applying a rotation rule to some other subset of issuer audits? For example, are there reasons for applying a rotation requirement only to audits of companies in certain industries?

(6) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

IV. Possible Approaches to Rulemaking
C. Transition and Implementation Consideration

(7) To what extent would a rotation requirement limit a company's choice of an auditor? Are there specific industries or regions in which a rotation requirement would present particular difficulties in identifying an auditor with the necessary skills and expertise? Is it likely that some smaller audit firms might decide to leave the public company audit market due to the level of uncertainty regarding their ongoing client portfolios?

(8) If rotation would limit the choice of auditors, are there steps that could be taken to allow a company sufficient time to transition out of non-audit service arrangements with firms that could be engaged to perform the audit? Are there other steps that could be taken to address any limitation on auditor choice?

(9) If rotation were required, would audit firms have the capacity to assign appropriately qualified personnel to new engagements? If they do not currently have that capacity, could firms develop it in order to be able to compete for new clients, and would they do so?

(10) Would rotation create unique challenges for audits of multinational companies? For voluntary rotations that have taken place, what have been the implementation and cost issues and how have they been managed?

(11) Would increased frequency of auditor changes disrupt audit firms' operations or interfere with their ability to focus on performing highquality audits? How would any such disruption vary by firm size? For example, would a rotation requirement pose fewer or more implementation issues for small firms than for large ones?

(12) Would audit firms respond to a rotation requirement by devoting fewer resources to improving the quality of their audits? Would firms focus more on non-audit services than on audit services?

(13) Would rotation have any effect on the market for non-audit services? Would any such effect be harmful or beneficial to investors?

(14) Some have expressed concern that rotation would lead to "opinion shopping," or that in competing for new engagements firms would offer favorable treatment. Others have suggested that rotation could be an antidote to opinion shopping because companies would know that they could not stick with a firm promising favorable treatment forever. Would opinion shopping be more or less likely if rotation were required? If rotation limits auditor choice, could it at the same time increase opinion shopping?

(15) What effect would a rotation requirement have on competition for audit engagements? If competition would be increased, how might that affect audit quality?

(7) We believe a mandatory rotation requirement might intensely limit a company's choice of an auditor. If the audit firms have to be changed regularly, a new auditor would probably have to audit the outcome of service which he provided before his engagement as auditor of the company. This could trigger the loss of independence of many firms.

In an environment requiring mandatory audit firm rotation, audit firms may not have sufficient incentives to accumulate specific industry knowledge, needed for a high audit quality in an environment of growing complexity.
In the end, audit committees might have to choose among firms with less industry expertise and will not be free to appoint the audit firm which best meets theirs needs and the needs of the shareholders.

(8) As outlined above we believe that a mandatory rotation requirement would limit the choice of auditors. We take the view that auditing of large multinational companies requires the existence of large audit firms, providing the adequate capacities, organisational structures as well as broad industry and highly specialized professionals to ensure audit quality. Smaller audit firms or networks out of numerous different audit firms are likely not to be able to provide such a service at equivalent speed, quality and uniformity. Accordingly, we believe only the Big 4 audit firms have the respective knowledge and infrastructure to provide audit and respectively non-audit services to large multinational companies.
Thus, if two of the Big 4 audit firms provide non-audit services (not uncommon in practice) and therefore are not independent, the current Big 4 auditor is not eligible to repeat as auditor, then the number of eligible audit firms is reduced to one firm.
Also for companies that operate in specialized industries the number of audit firms having the appropriate knowledge to perform a high quality audit might be reduced.
For large multinational companies there is no realistic possibility to switch for non-audit services from Big 4 firms to smaller firms as these do not have the infrastructure, resources and specific knowledge required to perform high-quality non-audit services for large multinational companies.
It is our view that the Big 4 firms have similar cultures, processes and procedures in performing audits, and as a result the benefit of a “fresh look” is very limited for company’s that are due to their operations in various countries and complexity more or less required to take a Big 4 firm as audit firm in order to ensure a high quality audit.

(9) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(10) Multinational groups might face significant practical problems with mandatory rotation, especially if different national regulations require rotation after varying amounts of time. Such a group would have to use different audit firms in countries that require mandatory audit firm rotation or change the audit firm of the group every time a rotation is required in a country where the group operates. Both alternatives increase costs and are from our point of view inefficient and might increase audit risk. In addition, as laid out above under (8) the choice of auditors for large multinational companies is limited.

(11) Yes, we believe that increased frequency of auditor changes would disrupt audit firm’s operations and interfere with their ability to focus on high-quality audits. The knowledge base and understanding developed by an audit firm over time are lost upon rotation, thereby increasing the costs of maintaining the same quality of audit service for the successor audit firm.

(12) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(13) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(14) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(15) In the current environment we see no evidence of impaired competition. Regardless of mandatory audit firm rotation requirements smaller audit firms will still be unable to compete for the audit of large multinational companies due to different reasons, such as expectations of the capital markets to use Big 4 firms, a lack of resources or a lack of industry knowledge. However, we see an unintended negative effect of intensified competition as a consequence of mandatory audit firm rotation: there is an increasing pressure on reduced audit fees that might not support an appropriate level of audit work, and thus lower audit quality.

(16) Are there any requirements the Board should consider to mitigate any risks posed by rotation? For example, are there enhancements to firms' quality control systems that might address such risks?

(17) If the early years of an auditor-client relationship pose higher audit risks than later years, should the Board require firms to provide additional audit supervision and oversight in the first year or two of a new engagement? Should the Board impose such a requirement for auditor changes even if it does

not further consider requiring audit firm rotation? If firms are accepting new clients but are unable to perform quality audits for them until several years have passed, should the Board require enhanced client acceptance procedures? What impact would additional requirements of this type have on audit costs?

(18) If mandatory rotation were required, are existing standards relating to communications between predecessor and successor auditors sufficient? Should additional communications be required? For example, should the outgoing auditor provide the incoming auditor with a written report outlining audit risks and other important information about the company?

(19) Are there other audit procedures that should be required to mitigate any risks posed by rotation?

(20) If the Board moved forward with development of a rotation proposal, should consideration be given to the recommendation for a cause restriction on the company's ability to remove an auditor before the end of a fixed term? Would such a provision be useful? Would there be unintended consequences of such a requirement? Should the Board work with the SEC on implementation of this recommendation? Are there other matters on which the Board should coordinate with the SEC?

(21) What other transition issues might arise in the first year of a rotation requirement? How should the Board address these issues?

(16) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(17) In the early years of an auditor-client relationship overall audit quality is likely to be lower than in later years if not compensated by a stringent transition process and the necessary investment by both, the audited company and the external auditor. Therefore we see the need for a stringent transition process and we believe a requirement for audit firms to provide additional oversight in the first year of a new engagement will help to increase audit quality, especially in circumstances where the successor audit firm accepts a lower fee for the audit services than the predecessor audit firm.

(18) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(19) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

(20) We believe that the audit committee is in the best position to decide whether, and when, to rotate auditors and thus is the relevant body to remove an auditor if the audit firm's performance is not sufficient. However, as laid out above we object to the introduction of mandatory audit firm rotation and therefore do not see any matters with regard to mandatory audit firm rotation that the Board should coordinate with the SEC.

(21) As laid out in the General Questions above we object to the introduction of mandatory audit firm rotation.

If you have any questions please do not hesitate to contact Nikolaus Starbatty (nikolaus.starbatty@siemens.com, phone: +49 89 636 36371).

Sincerely yours,

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